

The following two articles by Cliff Weight, a Director of MM & K, were published in the May and July editions of Financial World.

HOW BANKERS SHOULD BE PAID

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The way bankers are paid does not work. In most cases the expected value of an executive's pay package will increase if his actions increase tail risk, tracking error and share price volatility. Executives receive asymmetric returns: they are not aligned with shareholders.

Most banks operate a simple rule that no more than 50% of net revenue should be paid out as pay. This is fine in theory, but most banks break their rule when income does not meet expectations.

Another typical rule is that a team/unit will share 20% of the profits between the team. The exact percentage will vary between the type of business, the particular skills of the team and their leverage in negotiation.

The banking pay problem is complex. A good start is to consider these ten issues:

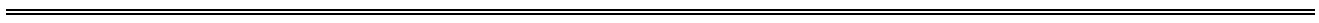
1. Not enough bonus is deferred. The lack of handcuffs means that executives can move elsewhere and have too much leverage in their pay negotiations.
2. No "claw-back" if losses occur next year. Deferred pay should be contingent on future profits. A particularly case is when bonus is paid on "paper" profits, which may not recur in future years, or which fail to generate cash. MM&K do a lot of work with private equity companies, whose executives receive their incentive pay based on "cash on cash" returns - so aligning their interests with investors. Their incentives are also usually based on whole fund returns, rather than on a share of each investment, thus if one project fails the others need to make up for it before the executives receive any incentive pay.
3. No link to risk. "Profits" are not worth so much if there is a higher risk of losses.
4. No cost of capital. If a team/unit needs capital (or trades off the parent bank's credit rating) then the cost of capital (risk adjusted) should be charged prior to sharing profits.
5. It is also very difficult in some areas to identify whether the financials have been due to good performance or to luck. Some will argue that it does not matter. It is a question of culture whether you pay for financial measures, behavioural measures under the control of management, or take account of both. The affordability argument drives companies to link rewards to financial measures. Making pay a variable cost rather than a fixed cost makes strategic sense when it is a large part of the cost base. But when guaranteed bonuses are awarded, the "variable" cost becomes semi-fixed and the company loses both ways. Employees whose pay is based on financial measures may perceive higher levels of personal risk and demand a higher expected value of pay to compensate.
6. Does Tiger Woods' manager get paid more than Tiger? Of course not. Not by a long way. Yet many banks assume the manager has to be paid more than those in his/her team. I am not saying the star culture is wrong, just remember that the team manager is not (always) the "star".
7. Banking is a people business. Banks cannot grow without the people. If banks see an opportunity and wish to exploit it, they have to redeploy existing people or recruit externally. External recruits demand guaranteed bonuses. Hiring people is risky - at least 25% of senior recruits fail. Banks' HR strategy should be to recruit very few senior people: and instead to grow their own. Banks need to be tremendously effective in hiring high quality graduates/MBAs and growing them into partners/directors. Goldman Sachs do this very well.
8. The pay problem starts at the top. The US model of CEO pay is broken. It has been for years. Enron, WorldCom, Tyco, NYSE and Hollander are examples of the CEO having too much influence in setting their own pay. This is still the case as is shown by the large payoffs to the CEOs of Citigroup, Merrill Lynch, etc.
9. Executives do not think and act like owners, because their pay does not encourage them to.
10. The Turnbull Report asked Boards to consider: "*Do the company's culture, code of conduct, human resource policies, and performance reward systems support the business objectives and risk management and internal control systems?*" Did the Board's of Northern Rock, Citigroup, Merrill Lynch

and UBS consider this question? Boards need to pay more attention to Turnbull and establish ways to check that the incentives and pay arrangements support the culture the company wants.

Will things change? Will they get better?

There are 4 stages in change >>> 1. DENIAL>>> 2. ACCEPTANCE>>> 3. PLANNING>>> 4. IMPLEMENTATION.

I doubt much will change quickly. Most bankers are just about moving from Denial to Acceptance. This article is evidence of change. If you want to create value for your shareholders in the long term, it is time to move to the planning stage and start looking at better ways to pay people.



HOW BANK CEOs SHOULD BE PAID

Article by Cliff Weight, of MM&K remuneration consultants
Published in Financial World July 2008

In May's Financial World I explained that the way bankers are paid does not work. However to change bankers' pay will require leadership from the very top. I believe this will not occur until banks change the way their CEOs are paid.

Part of the problem is that the US model of CEO compensation is broken. It has been for years. Enron, WorldCom, Tyco and Hollander are examples of the CEO having too much influence in setting their own pay. This is still the case as is shown by the large payoffs to the CEOs of NYSE, Citigroup, Merrill Lynch, etc. Their remuneration committees approved the awards. Why?

Too many CEOs in the US have the combined Chairman and CEO role. They strongly influence the choice of their non-executive directors and ensure the Remuneration Committee consists of people minded to continue to vote through excessive pay awards. SOX does not address this problem. Laws and regulations about caps on pay will not work. There is bad precedent in the law of unintended consequences, e.g. s162 of the US Tax Code which limited pay to \$1m p.a. unless it was performance related, which led to a huge increase in the use of options and rises in previously sub-\$1m salaries up to the \$1m restriction.

Analysts contribute to the excessive pay levels of CEOs. Shares surge on the appointment of a big name CEO. Usually such CEOs command much higher compensation packages than lesser known internal appointments. To justify themselves, new CEOs have to do something. They adopt new strategies, which entail more risk. More risk = higher share price volatility* = more chance of a large payout if successful. New hires, not unreasonably, negotiate safety nets¹, in case things don't work out as planned. But they win both ways. The poor shareholder has to suffer the burden and cost of an asymmetric reward package.

Academic research (performed by people who do not have a conflict of interest) is conclusive: 70% of acquisitions and mergers do not add value. Nevertheless, CEOs are strongly urged to do deals by investment bankers, strategy consultants, accountants and lawyers, whose fees are paid when the deal is done, irrespective of whether the deal generates superior shareholder returns in the long term. An example is RBS whose incentives strongly encouraged its CEO to buy ABN Amro - his odds of achieving the maximum incentive payments were much higher by doing the deal than if he had not.

Banking crises occurred in 1973, 87/88, 91/92, 98 2001/02 and 2007/08. On average every 6 or 7 years. But most long term incentive plans have a 3 year performance period, so allowing CEOs to maximise their expected income by adopting risky business strategies. The cycles are out of synch.

Too often banks pay CEOs as superstar entrepreneurs rather than as excellent administrators. The role of CEO is neither entrepreneur nor administrator, but somewhere in between.

The ABI and others mean well, but their guidelines are too prescriptive and have:

- a. produced boilerplate remuneration schemes not suited to individual company circumstances; and
- b. allowed executives to maximise their personal wealth by following strategies that are not in the best interests of long term shareholders.

Bank CEOs do not think and act like owners, because their pay creates and supports a culture of short termism, high risk taking and incentivises asymmetric risks.

***Volatility – an explanation:**

Mathematically, volatility is the standard deviation of share prices expressed as an annual % figure. Thus a company with a 30% volatility will expect its share price to be within 30% of the mean market change with probability 64%; and within 60% with probability 95%.

Share options only pay out if the share price goes up, but there is no "give back" if the share price drops - the options merely expire worthlessly even though the accounting standard gives them a value!

Doubling the volatility increases the expected returns from an option by about two thirds.

Both options and LTIPs reward and incentivise higher volatility, which is not in the shareholders' best long term interests.

Those are some of the problems. I think the CEO pay problem is not insoluble. My seven steps to success are:-

1. Succession planning. If there are lots of other good internal people who can fill vacant slots, banks will not have to recruit externally and pay top dollar.
2. Emphasise teams and recognise leadership rather than superstars.
3. Make sure the Remuneration Committee is made up of independent directors, capable of standing up to the CEO's demands. Ensure the Remuneration Committee appoints its own remuneration advisers, who are independent. Critically evaluate input from advisers who also receive fees from management for other consultancy work.
4. Make sure the Remuneration and Nominations Committees work together and are aware of key executives' desires, motivations, ambitions, career plans, lifestyle goals, wealth and appetite for risk.
5. Beware of risk and volatility. Do scenario analysis and consider, in particular, tail risk. Take more account of risk when setting incentive targets and the level and timing of payments.
6. Be open with shareholders about the CEO's pay - how it is paid and why. Explain the link to performance and show this over a 5 year period. Consult the shareholders to find out what they want. The Combined Code permits companies to explain why they do not wish to comply with the standard approach.
7. Create an ownership culture. Make CEOs think about creating long term value.